The Free Market

"If you don't create a free market, a black market will emerge"

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EDITORIAL

A Reform That's No Shame: Ten Years with a Currency Board in Your Pocket

If some ten years ago we had talked about things such as "a currency board," "a pegged litas" or "an anchor currency," the overall majority of people would have shrugged their shoulders wondering. Today it is not a mistake to say that nearly everyone is aware of this monetary system. But this awareness did not come along just because people had taken special interest in it or because the idea of pegging the national currency - litas - had been actively propagated.

People in Lithuania are familiar with the currency board system because they have tested and experience it with their pockets. Being able to draw a fixed amount of the anchor currency for litas and vice versa at any time they needed and with no impediments, people have made friends with this simple and companionable system. More than that, they have not only tried it themselves but also have shaped a firm opinion about this monetary-policy regime.

If we were to rephrase a well-known expression, it would run like this: eliminate the currency board and you will realize how immensely significant it is for the people and the economy. This is all very true of Lithuania: politicians have encroached on a host of things good to people, but they have not ventured to dismantle this system and don't dare to do so today. At the moment, virtually no one doubts that this system will be preserved until the launch of the euro in Lithuania. And who can scrap the possibility that the European Central Bank who is contemplating serious change won't introduce certain elements of the currency board one day either.

On April 1, 2004 the currency board system in Lithuania marked its ten-year anniversary. It was launched by adopting the Law on Litas Credibility which tied the litas to a strong foreign currency at a fixed exchange rate. However, the fixed exchange rate is not the keystone feature of the currency board. The underpinning of this arrangement is a 100 percent reserve backing which ensures that every litas in circulation is freely convertible into foreign currency. At the start the anchor currency was the U.S. dollar, and on February 2, 2002 the litas was re-pegged to the euro. The reserve currency has been replaced but the system has remained in place. It is a system where a central bank's major task is to maintain foreign reserves, while the remainder of monetary policy is run automatically.

It was precisely this system's automatism that stirred hostility of its opponents, the partisans of an active monetary policy. These were really many in number - interest groups who sought to exert influence on the exchange rate of the litas and gain from that, politicians or bureaucrats who wanted ease-come litas into the budget, or academicians who believed sacredly that an individual at the helm of money can perform the mission much better than the flawless market would. There is no point in disputing with the former and the existing opponents today. Those who didn't trust the system have found answers to their questions in the ten-year history. Once foreshadowed, the bugaboos have not emerged. All the actively championed advantages of the currency board turned into reality: inflation was curbed, political discretionary powers were eliminated, the economy gained long-term stability, and money became the people's, not the government's, property. Lithuanians do not fear to join the EU's monetary system as they are actually already a part of it.

But the struggle was intense and fierce in the past. If to look at the history of ten to eleven years, it nevertheless seems incredible that confronting colossal resistance the architects of the currency board managed to install this system. The adoption of the currency board, make no mistake, has been the most steadfast reform ever effected in Lithuania. The Bank of Lithuania, who once stood firmly against its introduction, currently enjoys top ratings according to opinion polls. But it is not the ratings that matter. The pre-eminent thing about this reform is that it is no shame today.

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This issue of "The Free Market" is dedicated to mark the ten-year anniversary of the currency board system in Lithuania. It presents the outlook and evaluation of people who took an active part in the launching of this system ten years ago – both arduous prophets and fervent opponents of this idea. Let us take a look at the picture of the reform after ten years…

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Adolfas Slezevicius led the sixth government from 1993 until 1996. His cabinet proposed and implemented the adoption of a currency board system, by far the most successful economic reform in Lithuania. Mr. Slezevicius agreed to share his memories of the turbulent history of adopting a currency board in Lithuania, a history we can celebrate today thanks to the titanic efforts of the sixth administration and its supporters.

Reform Was Hard To Accomplish But I Would Do It Again

Interview with ex-Prime Minister Adolfas Slezevicius

Only a few countries in the world have a currency board arrangement. How did you discover it and how did you come to learn more about it?

Indeed, very few countries in the world opt for a currency board model, but that does mean it is ineffective. Currency board arrangements, with certain specific nuances, have existed in more than 70 countries during different periods. Virtually all of these countries have gained very positive outcomes from such a rigid monetary policy such as stabilizing the exchange rate, curbing inflation and stimulating economic growth.

I first learned about the currency board regime when it was being implemented in Estonia. At that time Estonia had achieved the highest rate of economic growth and stability as compared with other former Soviet nations. Equally attractive was the history of adopting a currency board in Argentina. In this country a currency board system was implemented after a severe bout of hyperinflation and as a result it helped to bring down inflation and achieve positive economic growth in a very short time.

These successful examples from Estonia and Argentina led us, in the light of the instability of the national currency, to learn more about the specifics of applying and operating this peculiar monetary policy arrangement. The interest in the currency board increased when the policy pursued by the Bank of Lithuania began to drive into despair not only the government but also business entities.

When talks about the possibilities of introducing a currency board in Lithuania began, Professor S. Hanke from the United States visited Lithuania several times to provide advice to the government of Lithuania. It was him who gave us an abundance of information about the advantages of the currency board and about other countries' experience in implementing it. We also obtained much information from representatives of the International Monetary Fund, first of all Mr. Knobl and Mr. P. Cornelius. IMF strongly supported the government's position in all stages of implementing the currency board.

I would like to particularly emphasise LFMI president Elena Leontjeva's role in advocating the currency board in our country. She personally and the Lithuanian Free Market Institute were very important aids of the government in promoting the idea of a currency board in Lithuania.

When and in what circumstances did you comprehend that a currency board system would be suitable for Lithuania? What led you to take a strong decision in favour of this model?

There were several factors that favoured the final decision of the government. First of all let me note that the currency board arrangement was implemented in Lithuania in very complicated economic and political conditions. The sixth administration, which took office at the beginning of 1993, inherited a particularly deplorable economic legacy. At that time the average wage in national currency was 27 U.S. dollars, while the average pension was 9 U.S. dollars. And this negligible income lost much of its value every day in the conditions of hyperinflation which stood at 1,263 percent in 1992! According to the World Bank, only Armenia and Georgia out of 26 post-communist states suffered from higher inflation that year. But apart from the economic turmoil, these countries were also being shattered by civic war.

Our country's indebtedness to Russian companies for gas and nuclear fuel amounted to almost 100 million U.S. dollars. Apartments were faintly heated and had no hot water; petrol stations had no fuel; stores had no foodstuffs. The society was plunged in enormous social tension and hostility. Pickets and other disobedience actions were held in front of the government building almost every day. Political opponents sought to impede at every cost the economic reforms we pursued. So the ground for all types of economic speculations and public intimidation was particularly fertile. But the history of adopting the currency board had not even started then.

At that time the introduction of the national currency was the first priority. Thanks to the efforts of the Bank of Lithuania, this was accomplished during a very short period of time, during three months after the new administration and the new leadership of the Bank of Lithuania took office. We were the last of the Baltic States to introduce national currency, just like many other important economic reforms by the way. For this reason almost all micro- and macroeconomic indicators in our country were the worst of all Baltic States. It took us two or three years to catch up. Today Lithuania is more and more often labelled as "the Baltic tiger" and the leader of economic development in the region. There is no doubt that the currency board has played no small part in this success story.

Let me mention that hyperinflation was overcome with the introduction of the national currency. When the national currency was adopted in July 1993, the monthly inflation was a mere 0.7 percent, down from over 25 percent in April. Fragile foundations for economic growth were laid down. However, numerous monetary policy restrictions for business and individuals remained. Companies had much difficulty in buying and selling foreign currency. The exchange rate of foreign currencies against the litas swung heavily. The Lithuanian Industrialists Confederation and other business associations kept blaming the government for ruining companies and businesses. As you may know, the government had no powers or instruments to conduct monetary policy. By the estimates of the Lithuanian Industrialists Confederation, swings in the exchange rates of the litas and foreign currencies cost industrial companies a loss of 350 to 400 million litas of profits only in 1993. In the economic conditions of those days such losses were particularly painful. Naturally, this money did not just disappear. First of all it went to commercial banks.

It was obvious that the Bank of Lithuania and commercial banks were not satisfied with the situation. Calls from the government to bring order in this area were ignored. At that time the governor of the Bank of Lithuania increasingly demonstrated his wish to engage more in politics and commerce than in monetary policy. The notorious credit of 20 million litas extended by the Bank of Lithuania to "theirs" *Litimpex Bank* and political activities Mr. Visokavicius later embarked on only confirmed our suspicions.

These considerations led the government and first of all me personally as its leader and chair of the ruling party to initiate the removal of the governor of the Bank of Lithuania, Mr. Visokavicius, from office. My suspicions regarding his politicking proved correct very quickly. Shortly after his removal from the position of the governor of the Bank of Lithuania Mr. Visokavicius was at the forefront of the Conservative party's congress. His banking and politicking career cost the Lithuanian economy dearly at that time. Of course, his removal was seen as political dealing with a decent banker who modestly called himself no less than "Litas' father." A question that kept bothering me and others at that time was how much inexperience and how much conscious harm-doing with regard to the-then government there was in the Bank of Lithuania's actions. Maybe historians will answer this question some day…

The persisting instability of the national currency only reinforced the government's position on the need to adopt a currency board in our country. It became absolutely clear that only a monetary policy independent of biased leaders of the Bank of Lithuania and immune to political pressure could secure the stability of the national currency that was much needed by the Lithuanian economy and the people. The government had simply neither possibilities nor time to wait until, hopefully, the newly formed board of the Bank of Lithuania, led by newly appointed chair Mr. Ratkevicius, achieved the stability of the national currency.

My meeting with Argentina's economic minister D. Covallo during the 1994 World Economic Forum in Davos played an important role in the story of implementing a currency board in Lithuania. It was Mr. Covallo who was the main architect of very successful economic reforms, including the introduction of a currency board, in Argentina. Our long discussion revealed a host of aspects and benefits of having a currency board regime. This meeting dispelled any doubts regarding the need to adopt a currency board arrangement in Lithuania once and for all.

True, the possibilities of applying a currency board model in our country were briefly discussed at the sitting of the Litas committee when the preparations for introducing the national currency took place. The-then governor of the Bank of Lithuania, Mr. Visokavicius, strongly opposed the application of this monetary policy model in Lithuania. He assured that the Bank of Lithuania would secure the stability of the national currency. At that time I lacked experience and information, so naturally I was not able to assume an adequate position concerning the implementation of a currency board Lithuania. But there was no need to adopt a currency board at that time either. After all, central banks successfully applied classical monetary policy around the world. Unfortunately, this policy failed to justify itself in Lithuania through the fault of the-then governor of the Bank of Lithuania. It took almost one year after the litas had been introduced to implement the Law on Litas Credibility, a law which served to stabilize the country's economy and stimulate growth.

It is natural that introducing novelties always raises various discussions and emotions. Who supported you and who opposed you the most when the currency board system was being introduced? Can you tell us a little bit more about how responsible institutions and persons changed their attitudes in supporting or opposing this idea?

The introduction of a currency board in Lithuania required tremendous efforts from the government and, first of all, from me personally as its leader. During three years of heading the government I could not recall a single law that faced such a large resistance.

Commercial banks were the biggest opponents of this law. And this resistance was easy to explain. There is no easier way for commercial banks to earn money than in the conditions of unstable currency and inflation. Commercial banks used every possible means to influence the government's views on the adoption of a currency board in Lithuania. There were collective statements from commercial banks. Help was solicited from individual politicians and economists. In the last phase of adopting the law efforts were made, quite fruitfully, to influence even President of the Republic of Lithuania A. Brazauskas.

The press and other media teemed with various articles and opinions about the likely disastrous consequences of the currency board not only for Lithuania but for its statehood. The circle of the opponents was not narrow. It comprised such economists as Mr. Uosis, Mr. Terleckas, Ms. Visokaviciene and others plus politicians with various views and outlooks. Famous energetic dissident Mr. Terleckas was also at the forefront of the opposition.

There were even a few cabinet ministers who doubted the necessity to submit the Law on Litas Credibility to the parliament. These were economic minister Mr. Veselka and foreign affairs minister Mr. Gilys. Mr. Veselka's position was more understandable: he was always an oppositionist, sometimes even against himself. It was always interesting to listen to the proposals he presented to the government. Sometimes he managed to oppose even his own proposals, motivating that he had changed his opinion. But I could not understand economic professor foreign affairs minister Mr. Gilys. It seemed to me that a minister with good economic knowledge had to be the first to comprehend how inevitable and necessary this decision was in implementing the government's agenda. Obviously, commercial banks did not miss the opportunity to take advantage of the aforesaid ministers' position in order to exert pressure on other members of the cabinet. I am glad that these ministers remained a minority on this issue.

President Brazauskas' position was also very important in gaining passage for the Law on Litas Credibility. Let me note that President Brazauskas upheld the government almost until the adoption of the law. However, on the eve of the adoption commercial banks tried for the last time to change the government's position. At the initiative of president's advisor academician Mr. Rajeckas a large council was called. The participants included for the most part heads of commercial banks as well as governor of the Bank of Lithuania Mr. Ratkevicius, finance minister Mr. Vilkelis, leaders of the parliamentary faction of the Lithuanian Labour Democratic Party (LLDP) Mr. Karosas and Mr. Kirkilas, chairman of the parliamentary budge and finance committee Mr. Kolosauskas, chairman of the Economic Crime Investigation Commission Mr. Juskus, LFMI's president Ms. Leontjeva and others.

At the very beginning of the council I realized that the president had, to put it mildly, changed his opinion on the Law on Litas Credibility (many years of affiliation with the president made it easy for me to notice the change). I realized that heads of commercial banks had done their best. A hard conversation was in store.

And then the principle of the last source of information worked. The president was easily persuaded and could easily change his opinion, even on fundamental issues, drawing on the information he obtained last. I witnessed this yet another time at the end of my political career when the president changed radically his position concerning my removal from the position of the prime minister during one hour only. But this is another story….

So the president offered me to start. I said that it would be better if all members of the council spoke first. The composition of the audience determined the contents of the speeches. Most of the participants strongly opposed the adoption of a currency board arrangement in Lithuania. They repeated all of the traditional intimidations about the inevitable disasters that the currency board would bring if the law were adopted. Only LFMI's president Ms. Leontjeva and Mr. Kolosauskas and Mr. Juskus upheld the idea. The latter MPs had visited Estonia to familiarise themselves with the functioning of the currency board and thus became keen advocates of this model.

In the light of this absolute criticism of the Law on Litas Credibility even finance minister Vilkelis, who felt in which direction the president was steering the council, expressed some doubts. By the way, he was the last to speak so he could take a position that would suit any outcome. Mr. Vilkelis upheld the president's idea that the adoption of the law had better be postponed for some time until there was more information on hand. I knew quite well that *temporarily* meant *never*. This would have meant abandoning the idea altogether.

When the president realized that the outcome of the council was clear, he cheerfully gave me the floor saying: "You see, Adolfas, the majority arguments are very convincing and we'd better refrain from adopting the law in parliament. Maybe we could come back to this question some day."

It was obvious that the government's position had to be presented very clearly and categorically. I spoke very briefly: "Your Excellency. The government cannot secure economic stability in the conditions of such unpredictable swings in the exchange rate. Exchange rate fluctuations are only pumping money from the economy to commercial banks. By not being able to influence these processes, we are becoming their hostages. Therefore, the government cannot and will not change its decision to submit the Law on Litas Credibility for the third reading in parliament. If the parliament approves it [I already had the approval of the LLDP faction], you may refuse to sign it. If you do so, the government will resign. This will be a simple and civilized way out of this situation."

Obviously, the president and the majority in the audience did not expect a speech like this at all. The president did not anticipate such a turn and was evidently discontented. I could easily feel the president's dissatisfaction. In such cases his blood pressure rose, his face flushing red. I felt that the president made a great effort not to criticize my position. But no more discussions followed. Although I used to stay on after any conversation to discuss with the president one issue or another, this time we all departed without further ado.

The next day the parliament passed the Law on Litas Credibility. The president signed it and we never returned to this question again. But since then I have always wanted to ask the president who and in what circumstances had influenced him so that he was ready to decline the law.

So this is the story how the Law on Litas Credibility came into being despite intense debates behind the scenes and open discussions, lobbying and vehement opposition. Apart from other economic reform components, this law laid the foundations for the country's economic stabilization (meriting the label of "the long stabilizer" among the reporters), economic growth and a rise in people's real income.

What in your opinion were the main motives of the opponents: interests or simply fear and a lack of determination?

I am confident that interests were the main motive that determined the opponents' fierce resistance to the Law on Litas Credibility. And these interests were very big. These were both economic and political interests and both powerful and concrete enough.

Economic interests determined first of all the opposition on the part of the central bank and commercial banks. After all, a fixed exchange rate eliminated any possibilities to profit from swings in the exchange rate. I already mentioned the losses that economic entities incurred. These amounts did not disappear anywhere. They were redistributed from industry and other sectors for the benefit of commercial banks. This was the golden age of commercial banks. Hyperinflation, exchange rate fluctuations… How many famous "bankers" this period raised… Of course, these forces could not just take a neutral position and watch how the preparations for the introduction of the currency board proceeded. It was an out-and-out opposition. There were statements from bankers and commissioned articles with prophecies virtually about the end of the world if such a monetary policy model were adopted in Lithuania. Pressure was also exerted through individual members of the cabinet.

Political interests could not remain unexpressed either. After all, political opponents in most cases do not care about general interests of the state. The principle "the worse for the government, the better" is, unfortunately, the main motto for many politicians. I think that it was this principle that caused this fierce opposition to the adoption of the currency board. Many of them understood already then that this monetary policy would guarantee the growth of the economy and people's real income. Naturally, that was not in line with the interests and plans of the-then opposition, whose major goal was to instil in people the idea that the parliamentary majority and its composed government were not capable of governing the state. But the thought of waiting until the next legislative elections was disconcerting for them.

There were plenty of "troubadours" on the political barricades trumpeting about the collapse of the economy and even the state that the adoption of the Law on Litas Credibility would inevitably bring.

Naturally, you were confronted with difficult tasks and puzzling questions. What was the most difficult: choosing the anchor currency, securing sufficient reserves, persuading opponents or anything else?

Frankly speaking the most difficult job was to convince members of the LLDP faction in parliament that it was crucial to adopt the Law on Litas Credibility. It took hours and hours and hours. I solicited help from IMF representatives Mr. Knobl and Mr. Cornelius, LFMI's president Ms. Leontjeva and other specialists. We took advice from currency board specialist S. Hanke. We organized various publications and presentation of the currency board in the media. MPs Kolosauskas and Juskus visited Estonia and familiarized themselves with the functioning of the currency board system. This facilitated dialogue with members of parliament.

Of course, I am not talking now about political opponents and their committed economists. No arguments could suffice or convince them. They simply did not want the-then ruling majority, its government and the president to achieve positive changes in various areas of life, including the economy. The opposition followed faithfully the principle "the worse, the better."

In forming the Litas stabilization fund, we received tremendous help from IMF. Also, the repayment of Lithuania's pre-war gold reserves by foreign countries, first of all France and England, did not come amiss.

Why was the US dollar chosen as the anchor currency? After all, integration into the European Union was already being projected then.

The choice was not difficult to make. Almost all hard currency reserves in the Bank of Lithuania were in US dollars. Almost all trade transactions of Lithuanian economic entities with foreign partners were in US dollars too. At that time the prospects of Lithuania's full membership of the European Union in 2004 were very dim indeed. By the way, the introduction of the European currency, the euro, was only a plan then. As we all know, the euro as the common means of settlement in European countries was introduced only from the beginning of 2002.

How was the exchange rate set? Did anyone profit (in the bad sense of the word) from fixing of the exchange rate?

Fixing the exchange rate was not easy either. We held long and difficult negotiations with IMF, the Lithuanian Industrialists Confederation, commercial banks and other business associations. Industrialists wanted the litas-U.S. dollar exchange rate to be fixed at no less than 4.5 to 1 or 5 to 1. IMF credibly insisted that the exchange rate should be not higher than 3.2-3.5 to 1. After intense negotiations we reached not a bad compromise at all, to my mind. The litas-U.S. dollar exchange rate had remained 4 to 1 for almost six years until the litas was pegged to the euro. True, shortly afterwards the U.S. dollar depreciated markedly against the litas. Just for fun, remembering the saying of one Lithuanian political classicist, "who can deny" that the earlier strength of the dollar was not based on the strength of the litas…

I don't think that anyone profited from the fixing of the litas to the U.S. dollar. It was before the Law on Litas Credibility came into effect that profiting, large-scale profiting indeed, had taken place.

The currency board system did not appear in Lithuania overnight. How long did it take to implement the system?

Naturally an important decision like this could not have been adopted very quickly. Nevertheless, it took much longer than expected. It took no less than eight months from the promotion of the idea until the adoption of the Law on Litas Credibility in the parliament.

Can you count how many times attempts were made to abandon the system? Would you count them with your one hand?

There were many calls and intimidations to scrap the currency board model, but not a single political party in power dared to even start such a debate in the parliament. Argumentation on the part of individual politicians or industrialists could not be viewed as attempts to dismantle the system.

Ten years have passed since the currency board arrangement was installed in Lithuania. Do you think the system has justified itself? Would you make the same decision once again, and in general is it hard to implement such sweeping reforms?

It is my strong conviction that the very fact of celebrating the tenth anniversary of the currency board in Lithuania answers this question. This system has survived all parties which have been in power. I have already mentioned how strong the opposition was. It was claimed that this ostensibly disastrous monetary policy would end with the end of the LLDP tenure. During those ten years the opposition and other political parties had many occasions to abandon the currency board. However, no politician dared to even start debating this question, although there was constant pressure, especially from industrialists, to change the exchange rate of the national currency and the anchor currency. This confirms once again that the currency board arrangement, which has been applied for ten years now, has fully justified itself.

Reforms like this are indeed very difficult to implement. The government offered this decision although it was disadvantageous for the government itself. The government forewent the right to draw loans from the central bank, which lost the function of a lender of last resort. So this move required a great deal of political will on our part.

However, if I had to take this decision once again, it would be the same because it was exceptionally important and necessary. And it has excellently served the common good.

And what benefits has this system brought for people?

I can see several gains. Apart from other elements of the economic reform, a strict monetary policy first of all helped to curb inflation, or price rises. To quote one classical economist, it is inflation that robs and impoverishes unnoticed the whole society. Curbing inflation laid the foundations for the rise of the economy and people's real income. Higher pensions and wages and stable or slowly rising prices are the goals which all governments pursue, and societies count on their governments to achieve these goals.

A strict monetary policy pursued in Lithuania since April 1, 1994 has secured a rapid increase of gold and hard currency reserves. They grew almost 30 times only during the incomplete three-year tenure of the sixth administration! This laid the foundations for the long-term stability of the litas. And the winners of a stable national currency are first of all the people!

Thank you very much

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MEMOIRS

Ms. Elena Leontjeva was one of the active champions of the currency board system in the pats decade. Under her leadership, the Lithuanian Free Market Institute has advocated the idea of the currency board, strongly supported its implementation and helped drafting the law on litas credibility. As numerous attempts were made to scrap this system, LFMI and its President stepped in every time in its defence. In the following interview Ms. Leontjeva shares her recollections and explains the reasons why this monetary system was needed in Lithuania.

The Currency Board Helped Preserve Reliable and Shielded Money

An interview with Elena Leontjeva, LFMI's Chair of Board

In 1993-1994, as the President of the Lithuanian Free Market Institute, you supported strenuously the idea of a currency board arrangement and contributed significantly to its implementation in Lithuania. Why, in your opinion, this particular monetary-policy regime was the right reform path at that time?

After the trying ordeals of socialism, Lithuania has deliberately chosen the course of the free market, and money in such a market does not depend (or should not depend) on political or interest group pressure and has to serve people credibly in all its functions. In the past such money was gold and silver but it was abandoned gradually as people wanted to take the helm of money into their own hands. In those days Lithuania was contemplating an option to return to gold, but despite the fact that Lithuania had been under the gold standard until the USSR occupation, and certain sentiments to adopt this decision were felt, however, the circumstances were not pertinent to do so. The gold standard was no longer used anywhere else in the world, and this factor halted Lithuania (as would have done to any other small country) from reverting to it.

Clearly, the alternatives we had were scanty – either a currency board or a discretionary monetary system. The currency board was not an ideal system but nonetheless it helped to iron out an array of the most daunting problems that people faced. The essential characteristics of a currency board arrangement are these: a fully convertible currency and free movement of capital; a 100 percent backing of national money with foreign reserves; a stable, not interventionist, exchange rate of currencies; money shielded from any type of political manipulation, "dilution" or artificial revaluation; market interest rates secured from interventions and other features. Evidently, the sole advantages of the currency board are related to safeguarding money from discretionary decisions of the government.

The launching of the currency board system must have been a lengthy and complicated process, punctuated by furious resistance of its opponents. How the-then efforts seem after ten years? What events are embedded in your memory most conspicuously?

I remember most vividly Pope John Paul II's visit to Lithuania when the litas surged against foreign currencies twice (the reason was not heightened religious belief of course, but a restrictive policy of the Bank of Lithuania that curtailed the money supply). As a result of this policy, the country fell short of litas and the exchange rate of the national currency kept growing unremittingly. The business sector was paralysed, and it was impossible to envisage not only the yield on long-term investment but also the profitability of trade operations that last just for two weeks. All these disastrous effects were the result of the central bank's vain efforts to "calm down" the national currency.

The problem of money credibility and its protection from monetary authorities became as pressing in those days as never before. I took into account this issue and published an article in one of the leading national dailies, *Respublika,* describing a monetary system that could secure people from similar cataclysms. We had been debating this monetary-policy regime before the litas was launched in the country but everyone then seemed to be more concerned about having national money but less so about a mechanism of its issuance. Afterwards the idea of the currency board was introduced at the Economist club and other audiences. Then followed the invitation by Prime Minister Mr. Adolfas Slezevicius to discuss this topic in more detail. Mr. Slezevicius appeared to be a vehement supporter of this idea, and I believe this acted as the first turning point in the history of launching the currency board in Lithuania. Shortly after that, the International Monetary Fund promised the Lithuanian Government to back the implementation of the currency board, and this was the second decisive factor to go along. The third crucial contributor to the process was when the parliamentary fraction of the Lithuanian Democratic Labour Party upheld this idea and later voted for the draft law on litas credibility. This party proved that they had cared for the interests of ordinary citizens rather than for retaining "monetary sovereignty" and printing money at will.

I should add though that when I and the task force set up at the government were drafting the law on litas credibility people kept repeating to me that we were just wasting our time and that the interest groups will triumph at the critical moment and the Lithuanian Democratic Labour Party would step back. As if on purpose, the exchange rate of the litas stabilised, generating a natural thought that the tribulations were over and that Lithuania was no longer in need of this law on litas credibility. The ranks of opponents were swelling but this fact is probably not essential today.

As time went by, the number of supporters of this reliably operating system increased, and today no one would want to eliminate this system and no one prognosticates its "crumbling down." I think that the currency board was criticized in those days not just because its economic and financial merits were vaguely perceived. It might be that people in Lithuania were simply dazzled by the regained independence and lacked understanding that what they had retrieved was their freedom from various rulers and that it was not the rulers' boundless freedom to act as they please. Sadly, this principle was scarcely admitted into the realm of monetary authorities in Lithuania in those days. When people talk about problems that plaque Lithuanian society today, they usually point to those areas in which the principle of limited government has not found consistent and detailed expression. Take, for example, any sphere - land sales, construction permits, tax interpretation, etc. – all their ills take the same roots - the abuse of unconstrained power.

Lithuanian exporters and importers faulted the currency board system for failing to hedging them against fluctuations in currency exchange rates which led them to lose the markets. Can these arguments be justified?

This monetary-policy regime couldn't have shielded them from fluctuations in exchange rates as such is not its purpose. It has safeguarded money from government and interest group intervention and has fulfilled this function without rebuke. There were at least several episodes in the history of the currency board when the government was tempted to solve problems by slipping its hand into the pockets of all of us. The said occasions were the crisis of the banking sector in 1995 and the break-up of the state finance system in 1999. In fact, inflation and devaluation have been (and remain) the constant phenomena of life in all of Central European countries that have no similar scheme. The exception is Latvia which has no safeguards set by law but the principles of the currency board are enshrined in the rules of Latvia's central bank. As for exchanges rates - just imagine a situation in which our monetary-authorities try to please one and then the other interest group! The exchange rate would be leaping about at such frequency and amplitude that any stable exchange rate would seem salvation for people.

I understand very well that the issue of fluctuations in exchange rates is very important, and often even grievous, for those working on the outside markets. But the exchange rate of the euro and the dollar would fluctuate anyway – whether the litas be pegged to either of these currencies or "unleashed" from any anchor (well, unless we believe seriously that the litas "props up" any anchor currency it is linked to). Fluctuations in currency exchange rates would remain a problem for Lithuanian companies all the same, only it would be accompanied by yet another day-to-day conundrum – the question of the exchange rate of the national currency to the dollar, the euro and all the rest of the world's currencies.

As money is the expression of all, it is human to cast the blame on it when things go wrong, although the dissatisfaction should be aimed at completely other targets. If income is lower than expenses, it's not money to blame, even though money is used to express a result. It is true, there is one more aspect of such discontent. When currencies in the rest of the world are ruled by national governments that try to be "good" to their own manufacturers, to have stable money becomes a tough test. It resembles a duel of a decent man with the one who is treacherous and cheats. And on top of that, your own "anchor" is not without sin either. It is baffling, indeed. Luckily, Lithuanian manufacturers and traders have survived in this struggle. More than that, their competitiveness rests on their own capacities rather than injections of continuously devalued money. They have prepared to compete in Europe's and the world's markets much better as compared to those who are used to working in the environment of constantly depreciating currencies.

Lithuania is bound to renounce the currency board system in several years and join the European Monetary Union where the central bank is an active player in forming monetary policy. Is there any probability that the principles of the currency board could be applied to policies pursued by the European Central Bank?

The euro is the only anchor currency in all member-states, so the principles of the currency board have already been implemented, but only with respect to national banks, not the European Central Bank. Is there any chance to propose this bank linking the euro to any other currency? It sounds like a joke, although pegging in currency board arrangements is just a mechanical principle, while at the bottom lie constrained powers of monetary authorities and non-intervention into the market. This is a relevant issue, and there is much to think about! After all, there is no such thing as "market interest rates" in the world any more, and what we call market interest rates here in Lithuania, indeed, is just a derivative of the administratively fixed interest rates of the world's major currencies, just small adjustment according to the market. Since the time central banks started commanding the money market, the market as such has vanished. For this reason the gold standard was bound to wane as it had been a roadblock to central bankers' unrestricted ruling of money, an unhandy "harness" of their power.

I think that developments and trends in the currency "market" are signalling that tools will be searched to limit government interventions and to revert to the market with a genuine non-administratively set price of money. It wouldn't matter then who would issue money and what their colour would be. It would reflect the fundamental phenomena of the economy rather than the government. Perhaps the most consequential aspect of our "experiment" is that we have preserved money protected from government discretion and have witnessed that such a leash remains purposeful in the modern age of the man's power.

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OPOSITION

Mr. Gitanas Nauseda is considered to be among the most vehement opponents of the currency board system. When this reform was piloted through the Government and the Parliament, Mr. Nauseda worked at the Financial Institutions Division of the Bank of Lithuania and voiced his opinion in one of the leading national dailies, Lietuvos rytas. Let us take a look at how the story of the currency board is viewed by its opponent after ten years…

A Currency Board was One out of Many Options of Monetary Policy

By Dr. Gitanas Nauseda, Adviser to President, *Vilniaus Bankas*

"I am against gold fetishism, against unseen passiveness which people display by consciously refusing to control the money they themselves print and by shifting responsibility to the unfeeling international gold standard." These are not my thoughts. These are Keynes' thoughts laid down in his early book "A Tract on Monetary Reform." However, I would sign under these words without reservations. It does not matter that they refer not to the present-day currency board but to the gold standard. After all, differences between these two are only minor.

It is somewhat strange to see people believe that money – the creation of their own hands and mind – can best be governed only by economic laws independent of their will and consciousness. It is my opinion that the best solution is to entrust money to specialists who are good at economic laws and at the same time to shield the central bank from political interference by law. A model like this existed in Germany for many decades. It has been successfully applied in the United States. Today no one in the United States would even consider seriously whether it would be better to have A. Greenspan (together with his team capable of smelling an economic recession before it actually starts) or automatic rules of the game. Naturally, small countries have fewer options because they need to pay heed one way or another to strong world currencies. But even in this case there are always several alternatives.

In order to answer the question whether a currency board was the most suitable arrangement for Lithuania in the past decade, we would need to test other variants in practice. Unfortunately, this is not possible. For example, the central bank of Latvia under Repse's leadership has performed no worse than our currency board. But this does not mean that in similar circumstances Lithuania would have succeeded in pursuing just as an effective monetary policy. It is not only the central bank's governor but also a host of other factors all of which cannot be evaluated *a priori* that determine success.

It has never been my opinion that there is only one optimal choice of monetary policy, while all others are bad. Much depends not so much on monetary policy *per se*, but on the combination of monetary and fiscal policies (as well as other components of economic policy). In this respect monetary policy decisions can be divided into very good, good, satisfactory, bad and very bad. Although at first I was sceptical about currency boards, I think it would be simply unfair to label them as either bad solutions or very good solutions.

The currency board as a special monetary system has played no small part in stabilizing the Lithuanian economy. Two or three years after the currency board had been installed inflation and nominal interest rates fell down markedly. In addition to that, the currency board has proved to be a fairly good safeguard against the government's expansionary financial policy. Under a floating exchange rate regime, fiscal policy errors frequently go unnoticed as a reduced exchange rate of the national currency against foreign currencies can always be blamed on improper decisions of the central bank. Under a fixed exchange rate arrangement (under a currency board system) an overly generous fiscal policy causes a loss of official foreign reserves and an increase in interest rates. When budget expenditures and borrowing needs on the domestic market grow *and* there is no possibility to borrow directly from the central bank, the state is forced to seek private creditors (banks, insurance companies, etc.) who would agree to extend more expensive loans. In extreme cases voluntarism in financial policy may "bar" the central market to the state altogether and put the state on the edge of a financial crisis. We faced a situation like this in the second half of 1999, and later on this experience taught our politicians a good lesson not to repeat past mistakes.

By denying the central bank the power of discretionary regulation of money supply and interest rates, the currency board made the central bank an improper target of political pressure. Indeed, how could the Parliament or the Government force the central bank to cut down interest rates or to "correct" the exchange rate or to extend a loan to finance a budget deficit if the central bank did not have a right to do so? Lithuanian politicians mechanically kept attacking the Bank of Lithuania with various requirements with the view to gaining short-term political dividends (for example, Prime Minister Gediminas Vagnorius advocated the idea of using official foreign reserves to stimulate domestic crediting), but after several years they perceived the futility of such efforts.

On the other hand, life has shown that a currency board can neither protect the banking system from upheavals nor be a kind of a substitute for the supervision of credit institutions. Quite the contrary. An effective and rigid supervision of a banking system is essential for a successful performance of a currency board. At the turn of 1996 inadequate control of credit institutions (both legitimate and illegitimate) provoked a banking crisis during which restrictions imposed by the currency board proved to be completely ineffective in putting out "the fire." This forced the authorities to violate the principles of a "pure" currency board and to temporarily change the rules of the game, i. e. to revoke sanctions applied to commercial banks for non-compliance with mandatory reserve requirements, to provide liquidity injections for some of them and the like.

I think pegging the litas to the US dollar and not the German mark, as Estonia did, on 1 April 1994 was a mistake. The advocates of the currency board chose a passive approach, instead of a pro-active one, towards the choice of the anchor currency. They took into account the then obviously dollarised foreign trade and composition of loans, deposits and the currency market. On the one hand, this reduced the economy's vulnerability to fluctuations in the exchange rate. On the other hand, it "conserved" a high degree of dollarisation for a long time. Later Lithuania's integration into the European Union led the authorities to break the "conservative" currency board system and to re-peg the litas to the euro at the beginning of 2002. For subjective reasons, i.e. by pegging the litas to the euro at the time when the euro's exchange rate was particularly low in relation to the US dollar, this re-pegging was financially very painful for the country's inert deposit holders who continued to keep their deposits in US dollars and suffered tremendous losses.

When I think about the currency board's mission and Lithuania's upcoming membership of the European Union and the European Monetary Union, I recall an old maxim "the Moor has done his job, the Moor can go." We intend to join the EU common currency space which champions discretionary monetary policy and an active central bank. There is some merit of the currency board in that Lithuania stands out from among Central and Eastern European countries as fairly well-prepared for financial integration. Unlike for many other acceding countries, for Lithuanian business a fixed exchange rate is not a new *status quo* but a customary and familiar condition of doing business.

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STUDY

Mr. Sigitas Siaudinis is Head of the Monetary Policy Division of the Bank of Lithuania, Ph.D. He has studied the operation of the world's currency board arrangements and has defended a doctoral dissertation on this topic at Vilnius University. Ten years ago Mr. Siaudinis was among the many opponents of the currency board system but later changed his opinion.

Changing Attitudes towards Modern-day Currency Boards During Ten Years of a Currency Board in Lithuania

By Dr. Sigitas Siaudinis*, Bank of Lithuania

Lithuania's currency board is entering its tenth anniversary at a time when the country's economy has shown a robust growth for several years now. The country also meets all of the Maastricht criteria applied to EU member-states that wish to join the euro area. Most Lithuanian and foreign experts as well as the society uphold Lithuania's goal and possibilities to retain the present exchange rate of the litas and the currency board both when Lithuania joins the Exchange Rate Mechanism II (ERM II) (the interim phase required by the European Union to assess a country's readiness for membership of the euro area) and participates in ERM II until membership of the European Monetary Union. However, currency boards in Lithuania and elsewhere have not always enjoyed such friendly attitudes. In fact, these attitudes have changed significantly over the past ten years.

Lithuania adopted a currency board in the last decade of the past century, during this model's Renaissance. Three years earlier (in 1991) a currency board arrangement was installed in Argentina. In 1992 Estonia launched one, and in the third year of Lithuania's currency board, this model was implemented in Bulgaria and Bosnia.

At that time the opinion among the academics and monetary policy executives prevailed that a currency board was a suitable mechanism for quickly stabilising the currency of a developing country and gaining confidence in it (the latter motive prevailed when a currency board was being implemented in Lithuania, where hyperinflation had been overcome before the currency board was introduced). Many thought that currency boards would not be stable regimes because the economy had a limited degree of flexibility, as the common view was, in reacting to stronger external shocks, the authorities lacked determination to enhance this flexibility by pursuing structural reforms and commitment to rigid fiscal policy and because there was a growing likelihood of a liquidity crisis in a naturally developing financial sector.

* The author's fields of activity: implementation of monetary policy and money market. The author's views expressed in the article do not necessarily represent those of the Bank of Lithuania

Therefore, a currency board could be just a temporary "shield" in active preparations for a more flexible monetary policy or for joining a suitable monetary union (if such existed), while a sudden collapse would have been very painful (for more see R. Kopcke (1999)).

During the first years after the adoption of a currency board in Lithuania, the country's membership of the European Union, not to mention the then springing European Monetary Union, looked distant and uncertain. For many, the revival of our economy seemed too slow, and the young financial system experienced quite a few bank failures and a systemic crisis at the end of 1995. In such circumstances the new ruling rightist majority (the autumn of 1996), supported by many prominent Lithuanian economists (including central bank economists), adopted a plan for a gradual exit from the currency board arrangement. This plan was spelled out in "Monetary Policy Programme of the Bank of Lithuania for 1997-1999." As markets predicted depreciation of the litas, interest rates remained high until 2001 although the average annual inflation rate fell to a one-digit figure in 1997 and has stood below 2 percent since 1999.

Ironically, when the Russian crisis severely injured the Lithuanian economy in 1999, the plans to abandon the currency board, which until then had been considered an inflexible regime that impeded proper reaction to changing economic conditions, were postponed. At that time the official obligation to retain the currency board arrangement for some time and to tighten up fiscal policy, which the government of Lithuania assumed towards IMF while negotiating the renewal of the Stabilization Programme, made it possible to avoid insolvency with the help of foreign loans drawn in 1999. (The agreement with IMF was formally signed in March 2000, i.e. after the critical period for government finances had been overcome).

When the second-generation currency boards proved their vitality and collected longer time series of economic data, prominent experts announced research studies showing the effectiveness of currency boards as long-term strategies (A. Ghosh (1998); A. Gulde (2000); L. Batiz (2000)). Following international discussions in 1998 and 1999, EU institutions officially announced in 2000 that a country with a currency board arrangement would be able to join ERM II and prepare for membership of the euro area (the ECB president declared this position in April 2000; the European Council announced special statement in Nice, December 2000). At the same time EU authorities emphasized that a currency board would be a unilateral commitment on the part of its home country to comply with a stricter regime than required by ERM II. Country's possibility to maintain a fixed exchange rate and a currency board was to be considered individually in accordance with general procedures of multilateral negotiations by evaluating this model's stability and suitability for the country's convergence with the economic nucleus of the euro area.

Three out of the four best known and currently functioning currency boards are in countries seeking membership of the European Union and the euro area. These are Bulgaria, Estonia and Lithuania. These countries are planning to preserve their currency board arrangements until they join the euro area. Lithuania's clear aspiration to join this monetary union, the expected not too distant accession into the union, a competitive economy, fiscal discipline, a fairly healthy and undeveloped banking system (the low risk of a liquidity crisis in the case of the contraction of money demand), an objectively small internal financial market (the little space for speculative attacks), obligations towards EU institutions to proceed with structural reforms in order to increase the economy's flexibility – a combination of all these factors have markedly increased confidence in the country's currency board system so that even conceptual critics of this exchange rate regime have recognized its success.

The level of real income (GDP in PPP per capita) and prices in Lithuania are slowly converging towards the richer EU countries but now it constitutes only 40 to 50 percent of the euro area average. Therefore, despite a long period of higher inflation, the real exchange rate of the litas remains considerably undervalued. In terms of the exchange rate, Lithuania has a long way to go to a long-term equilibrium towards which it is gradually converging. However, Lithuania does not stand out in the trajectory of the current and acceding EU member-states in terms of the real income and price level.

Under such circumstances it would be difficult to prove that a different exchange rate regime would be better and negative consequences of its replacement would be too obvious. The opponents of the currency board in Lithuania did not offer any convincing alternative exchange rate mechanism. They did not dispel the doubts regarding its transparency either.

Hong Kong's currency board has faced much bigger challenges than the future EU member-states. In the light of accelerating integration with the Chinese economy, whose price level is several times lower than that in Hong Kong, Hong Kong's economy has experienced a prolonged deflationary downturn. At the same time plans of a monetary union are not being contemplated due to the existing enormous economic differences and limited convertibility of the Chinese currency. Nevertheless, both Chinese and Hong Kong authorities as well as prominent economists are of the opinion that it would be most beneficial to maintain the present exchange rate regime and to achieve more flexibility of the real economy.

The differences between the instruments of day-by-day implementation of a currency boards and the Eurosystem's monetary policy (i.e. differences in their operational frameworks) are obvious. They have been frequently emphasized by the opponents of the currency board. However, the trends of liquidity management of the banking system in the euro area show that this is not going to be a serious obstacle for countries with currency boards.

Since the monetary union came into being, large banks in the euro area have extended their liquidity management to the international euro market and have increasingly centralized management of their financial group's treasury. Small and medium-sized banks, like those in Lithuania, have increasingly orientated their activities towards the domestic market and in most cases managed their liquidity through transactions with the aforesaid international banks. The number of credit institutions directly participating in the monetary policy operations of the euro system and competing on the international scale has decreased to 4 or 5 percent of potential participants (institutions which are subject to the minimum reserve requirements applied by the ECB). So the interbank euro market is becoming increasingly important in redistributing bank reserves in the euro area not only domestically but also on the international scale. A currency board mechanism provides natural incentives for domestic banks to actively operate in this market in managing their liquidity.

When modern-day currency boards were being implemented, they were compared with their successful predecessors, the first generation (orthodox) currency boards which functioned in more than 70 colonies from the middle of the 19th century until the first half of the 20th century. The advocates and opponents of the currency board use the differences between these generations to support their arguments. The advocates of the orthodox model reproachfully note that the institutions implementing modern-day currency boards (usually central banks) have maintained some additional monetary policy instruments and the functions of banking supervision and a lender of last resort, and that they can thus distort self-regulation of the money supply and injure the long-term macroeconomic stability. The opponents contrarily emphasize that currency boards functioning in the modern financial markets should be more flexible as they are not flexible enough. Most advocates and opponents agree that modern-day models are not pure currency boards but rather quasi-substitutes.

Publications analyzing the peculiarities of currency boards and justifying this arrangement appeared at the close of the last decade of twentieth century (C. Ho (2000). However, this topic was not yet profoundly analysed, most likely because the second-generation currency boards also ensure self-regulation of money supply. So the main question revolved around the choice between a currency board and more flexible exchange rate regimes.

It would be difficult to prove that the collapse of the currency board in Argentina (in 2001) was caused by its deviations from the orthodox standard rather than by fundamental factors, such as the appreciation of the anchor currency against the main trade partners, many years of wasteful fiscal policy, inflexible labour market, monopolized economy and inability to tighten up economic policies in the face of a crisis.

Still, a closer look at the circumstances under which modern-day currency boards are functioning and at their general features distinguishing them both from the orthodox model and other fixed exchange rate regimes of today makes it possible to avoid many disputes.

Orthodox currency boards were a handy mechanism for colonies in transforming the currency of the metropolis for local use. The central bank of the metropolis performed the functions of banking supervision and a lender of last resort to the banks whose branches composed the banking systems in the colonies.

The modern-day currency boards are in most cases chosen by independent states. These models are also based on self-regulation of money supply, but they bear more responsibility than their predecessors for preserving the stability of the banking system. They are also operating under conditions of much more sophisticated financial markets and more mobile capital movements. In addition to the features of the orthodox model (free capital movements, a fixed exchange rate established by law and automatic buying and selling of the anchor currency), they have the following peculiarities:

1. The legal requirements of backing the national currency with the anchor currency reserves are less strict: the requirement is to back only part of the central bank's liabilities (the money base, as in Argentina), liabilities in national currency (Estonia and Lithuania) with general and not net international reserves. Such milder requirements were determined by the established backing of the central bank's liabilities before the currency board was introduced and a wish to maintain the function of a lender of last resort in the case of systemic banking crises whose likelihood was particularly high at the beginning of financial stabilization. The qualitative change in adopting currency boards was not in complete backing but in a switch to automatic money supply tied to the dynamics of the balance of payments. It should be noted that reinvesting part of the profit earned with foreign assets allowed many of the long-standing currency boards (including those in Estonia, Hong Kong and Lithuania) to reach the orthodox standard – an excess of the central bank's net foreign reserves over all of its domestic liabilities.

2. The operating of first-generation currency boards was usually limited to the exchange of notes and coins. Currency boards functioning in the modern financial markets implement a faster and cheaper way for self-regulation of money supply. Exchange in non-cash form prevails. The main counterparties of the central banks as well as in the cases of the other modern exchange rate regimes are local banks which effectively indicate the net money demand of the economy. Not accidentally central banks organize the systems of interbank settlements and integrate them closely with the mechanism of the money supply self-regulation. The central banks in Bulgaria and Lithuania also directly exchange currency for government institutions. This frequently causes additional liquidity fluctuations in the banking system and "switches on" the self-regulating mechanism –exchange transactions between banks and the central bank.

3. By using additional monetary policy instruments, central banks implementing modern-day currency boards aim to maintain a buffer of the banking system's liquidity which banks are required to form without borrowing from the central bank and which makes the self-regulating mechanism more stable in periods of short-term fluctuations in money demand. The central banks in Bulgaria, Estonia and Lithuania apply minimum reserve requirements in this case, whereas the Hong Kong monetary authority forms an analogous buffer by issuing its debt securities among the banks. Previously the central banks in Estonia (from 1993 until 2000) and Lithuania (from 1997 until 2000) also conducted open-market operations to smooth liquidity fluctuations in the banking system. These disputable operations were forgone after banks had developed possibilities of liquidity management in domestic and international markets.

4. Comparison of modern-day currency boards with other fixed exchange rate regimes shows that actual backing is not a universal distinctive feature. In the last decade before membership of the euro area, the orthodox backing total domestic liabilities of the Austrian central bank was positive and bigger not only than that in Lithuania, but also than the Estonian backing in recent years. The analogous coverage in the Netherlands (prior to the monetary union) and in Latvia (at the present moment) is below 100 percent but exceeds the Bulgarian level. The most essential difference in these exchange rate regimes is reflected in the monetary policy instruments that the central banks regularly apply. Currency boards are traditionally based on self-regulation of money supply (on buying and selling of the anchor currency as initiated by commercial banks). Under other fixed exchange rate arrangements central banks seek equilibrium first of all with the help of open-market operations designed to maintain a level of interest rates on the money market corresponding to a fixed exchange rate. They carry out currency interventions in the second "defence echelon" of the exchange rate, but at the same time they tolerate bigger exchange rate fluctuations in the market around the official fixed exchange rate than currency boards do.

In generalising the peculiarities of the second-generation currency boards, we can say that these peculiarities stem from the aim to ensure the self-regulating mechanism of money supply in the environment of modern financial markets. For this reason the modern-day currency boards should not be labelled with a prefix "quasi."

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MEMOIRS

Mr. Kurt Schuler is Senior Economist to the Vice Chairman of the Joint Economic Committee of the U.S. Congress. More than a decade ago he and other prominent economists took an active part in making the case for the currency board reform in Lithuania. In the following article Mr. Schuler gives reminiscences on how the Law on Litas Credibility, which established the currency board system in Lithuania, saw the day-light in the country.

A Reminiscence on the Origins of the Law on Litas Credibility

By Kurt Schuler

The ideas ultimately embodied in the Law on Litas Credibility of April 1, 1994 began with a visit by a delegation of Lithuanian government officials and others to the United States in April 1990. The group was gathering ideas potentially useful for advancing Lithuania's economy and the cause of independence from the Soviet Union. The delegation visited George Mason University in Virginia, where I was a graduate student in economics. I was unable to meet with the group that day, but I wrote a short memorandum suggesting that the simplicity and robustness of a currency board would make it a good monetary system for an independent Lithuania. The memorandum was later translated into Lithuanian and published in the newspaper *Permainos*.

The delegation also visited Hillsdale College in Michigan. Coincidentally, the college was hosting a conference of economists of the Austrian School of economic thought. Among the participants was George Selgin, then an assistant professor at the University of Georgia. Selgin talked to the group and also suggested a currency board as an appropriate monetary system.

Hearing a currency board proposed independently by two people made a sufficiently strong impression on the delegation that in the summer of 1990 Selgin and I were invited to visit Lithuania. What the delegation did not know was that perhaps only half a dozen people in the United States knew much about currency boards at the time. Selgin and I were both influenced by our study of Hong Kong. In 1987, when he was an assistant professor at George Mason University, Selgin had received a fellowship from the mutual fund company G.T. Management. The fellowship paid the expenses of summer study in Hong Kong under the guidance of the firm's chief economist, John Greenwood. During the 1988-89 academic years Selgin returned to Hong Kong as a lecturer at the University of Hong Kong. In 1989, I received the G.T. Management summer fellowship. John Greenwood was then, as he remains today, probably the most knowledgeable person about Hong Kong's somewhat peculiar version of a currency board. He had been instrumental in returning Hong Kong to the currency board system in 1983, as a way of ending a severe currency crisis.

During the summer of 1990, Selgin arranged financing for our trip from the George Edward Durrell Foundation, an organization devoted to the study of monetary questions, and the Atlas Economic Research Foundation. Together, we wrote a draft paper containing ideas on monetary reform as well as some other topics. I presented it to a seminar at George Mason University, while Selgin solicited comments from a few economists around the United States. Milton Friedman gave a characteristic reply, politely but firmly pointing out some defects with the draft.

We visited Vilnius in late October 1990 for a week or so as guests of the Bank for Industry and Construction (*Promstroibank*). We met with a number of officials, including the bank's president, Romualdas Visokavicius (later president of the Bank of Lithuania); the Prime Minister, Kazimiera Prunskiene; and the Chairman of the Supreme Council, Vytautas Landsbergis. George Selgin also spoke at the Institute of Economic Science. We were helped during our visit by Mr. Visokavicius, his wife, and a small group of other persons that included Kestutis Glaveckas, Elena Leontjeva, Petras Austrevicius, Vytenis Aleskaitis, and Remigijus Bartaska. The first three members of this group would later found the Lithuanian Free Market Institute (LFMI).

My impression of the centrally planned Soviet economy was that upon close inspection almost everything was shoddy and second-rate. The stores had displayed in the window but few goods on the shelf; restaurants had extensive menus but only actually served a few dishes, usually not prepared well; large apartment buildings had no sidewalks connecting them and no working elevators. The system was rotten, but most Lithuanians knew it was rotten, and they were preparing for the day they would no longer have to live under it. However, because the Soviet system had so long isolated Lithuania, the economic ideas of policymakers were heavily influenced by Soviet examples. We considered it a bad idea simply to imitate the Soviet central bank, for instance, with a Lithuanian central bank based on similar principles, and we expressed our doubts in an interview with the newspaper *Respublika.*

After returning to the United States, Selgin and I used the balance-sheet data and other information about the workings of the monetary system that we had gathered during our trip to refine our earlier ideas. The resulting paper that was, I believe, the first detailed proposal for a currency board in any centrally planned economy. We explained how Lithuania might generate the foreign reserves for a currency board. We suggested that the most appropriate anchor currency would be the German mark, since after Soviet rule ended, Lithuania's trade would turn increasingly toward Western Europe. Finally, we proposed how to handle some potential problems with the banking system.

We could not get our proposal published in the United States because it seemed too novel at the time. It was, however, translated into Lithuanian and circulated in Vilnius in photocopied form. We did not know then but later found out that another American economist, Joe Cobb, also recommended a currency board as a possibility for establishing an independent currency in Lithuania at a conference in Vilnius in November 1990. In March 1991, Prime Minister Gediminas Vagnorius invited us to follow up our previous visit, apparently as a result of reading our proposal. On our second trip, Mr. Vagnorius requested George Selgin to return to Lithuania and to bring colleagues if Selgin wished. Selgin therefore asked Joseph Sinkey, Jr., a professor of finance at the University of Georgia, and me to accompany him. Sinkey was the author of an authoritative and widely used textbook on the financial management of commercial banks. We arrived in Vilnius on July 30 and stayed a little more than a week. During our visit we were again helped by some of the same people who had been so hospitable the previous year, especially Elena Leontjeva. Ruta Vitkeviciute (now Vainiene) served as our translator on a few occasions.

Our impression from talking to government officials and observing the policies the Lithuanian government was enacting was that, as in 1990, the government and people knew central planning did not work, but lacked a clear alternative vision. The Bank of Lithuania was just translating Soviet regulations into Lithuanian and enforcing them. It had no plan for making an independent Lithuanian currency convertible. Its officials refused to meet with us. We expressed our scepticism of the bank's policy and of the coupon rationing scheme that had recently begun. After returning to the United States, we wrote a paper summarizing our ideas, which was published by the Cato Institute in Washington.

The Soviet Union ended sooner than we dared hope. The abortive coup against President Mikhail Gorbachev occurred later in August 1991 and Russia recognized Lithuania's independence in early September. Given the opportunity to pursue a monetary policy different from that of the Soviet Union, though, Lithuania did not establish a currency board. A central bank had support both within Lithuania and from the International Monetary Fund, which only had a few staff who knew much about currency boards. At a conference in

Indianapolis, Indiana in October 1991, sponsored by a group called the International Baltic Commission, two IMF officials told me they thought currency boards were not appropriate and not likely for the Baltic States.

In June 1992 Estonia established a currency board-like monetary system - not an orthodox currency board, but a combination of currency board and central banking elements. The Estonian system was influenced by a short book that I wrote with Steve Hanke and Lars Jonung. Jonung, who suggested the project, was at the time chief economic adviser to the prime minister of Sweden. As such, he was involved in Sweden's effort to help its Baltic neighbours in their transition to a market economy. Hanke was (and still is) a professor of applied economics at Johns Hopkins University in Baltimore, Maryland. He had learned about currency boards from Sir Alan Walters, a fellow professor and sometime economic adviser to British Prime Minister Margaret Thatcher. I had begun working with Hanke in the summer of 1990 because of our shared interest in currency boards. Hanke visited Estonia in May 1992 to discuss the currency board idea with members of the Estonian parliament. Jonung also visited Estonia and had contact with Estonian government officials and economists.

The success of Estonia's monetary reform combined with some problems under the original monetary policy of the Bank of Lithuania allowed creating renewed interest in a currency board. Without the untiring efforts of LFMI the idea of a currency board would not have received a second chance. The institute, especially Elena Leontjeva, wrote and talked frequently about the idea to many different audiences. When the time came that the idea was ripe to be reconsidered, LFMI asked Steve Hanke and me to write a short book as we had done in the case of Estonia. It was translated by Ruta Vainiene and published in February 1994. Like the proposal Selgin and I had made, it suggested that the German mark would be the most appropriate anchor currency.

During the debate about reforming the Bank of Lithuania's monetary policy, Steve Hanke visited Lithuania. He received an appointment as an official but unpaid economic adviser to President Algirdas Brazauskas and kept in contact with the president's office during the time the Law on Litas Credibility was being drafted. I had frequent opportunities to watch the progress of the drafting while working with Hanke in his office as he received frequent faxes and telephone calls from Vilnius. Hanke and I advocated an orthodox currency board. LFMI gave valuable support and advice to Hanke on the politics involved. Prime Minister Adolfas Slezevicius seemed inclined in our favour, but the Ministry of Finance, the Bank of Lithuania, and the resident representative of the International Monetary Fund were opposed, and tried to retain as much discretionary power for the Bank of Lithuania as they could. The final result was a currency board-like system somewhat like that of Estonia.

In many writings, such as a 1993 book proposing a currency board for Russia, Hanke and I have warned of the dangers of currency board-like systems. They contain incompatible elements, because the discretionary power characteristic of a central bank is opposed to the rules characteristic of a currency board. The problem is one of economic logic as well as politics. Argentina's currency board-like system came to a bad end in January 2002. Lithuania's system endured strains in during the banking crisis of 1995 and again after Russia's financial crisis of 1998. Fortunately, the government chose to adhere mainly to the discipline fostered by the exchange rate rather than to follow the more typical central banking path of devaluation. Again, the Free Market Institute played a key role, by making the case to the government and the public not to return to the policies that had already been tried before 1994 and been unsatisfactory.

The exchange rate of 4 litas per U.S. dollar survived. The switch from the U.S. dollar to the euro as the anchor on February 2, 2002 in a sense fulfilled the recommendations Selgin, Hanke and I had made years earlier to use the German mark. Lithuania will soon become part of the European Union, and it is on track to become a member of the European Central Bank with fewer exchange-rate problems that Poland, for example, may experience because of the difficulty a "pure" central bank has in maintaining a pegged exchange rate. The Law on Litas Credibility, while not perfect, was considerably better than the policy it replaced, and over the last ten years it has helped Lithuania develop into an increasingly prosperous market economy.

The ideas expressed in the article represent his personal views only.

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NEWS

Investment Climate Survey

The Lithuanian Free Market Institute is conducting an Investment Climate Survey which is aimed at generating establishment-level quantitative information that would help evaluate the performance of business enterprises and identify constraints to doing business. The survey was contracted by the World Bank and will be completed by 1st of May, 2004.

The survey is designed to provide firm level evidence on the impact of a wide range of policy reforms on business performance and the state of investment climate in Lithuania. The data from this survey will be compared with information from the World Bank's recent surveys to benchmark the competitiveness of the Lithuanian private sector against major competitor countries. The survey is tailored to be repeated in 3-5 years to assess the impact of government policies on private sector growth and productivity increases.

This survey will be the foundation of an Investment Climate Assessment which will be written by the World Bank's Europe and Central Asia Private Sector Development group.

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PRESS RELEASES

LFMI receives a Templeton Freedom Award

March 15, 2004 - The Lithuanian Free Market Institute (LFMI) has been awarded a prize of the Templeton Freedom Awards Program given in the category of Institute Excellence. Three institutes from The Czech Republic, Slovakia, and Serbia & Montenegro were other organisations from Eastern Europe which were granted the same award. Over 140 institutes from more than 50 countries took part in the Templeton Freedom Awards Program.

Supported and named after the pioneer of international investing, Sir John Templeton, the program rewards innovative and outstanding work of think tanks in countries throughout the world that promote the ideas of freedom. The Templeton Freedom Awards Program was launched in September 2003 with a four-year pledge from the John Templeton Foundation.

The Programme is directed by the U.S. Atlas Economic Research Foundation. Since 1981, this foundation has been the leading international organization for supporting independent think tanks advancing freedom.

LFMI has already received one prize from the John Templeton Foundation. In 2001 LFMI became a winner of the Sir John Templeton Foundation's International Freedom Project, directed by the Atlas Economic Research Foundation. LFMI has been awarded a grant for a semester-long course „Individual, Society, Freedom, Market." LFMI's fellow workers have been giving this course in Lithuanian universities for four years now.

The goals of the Lisbon agenda are hardly compatible, says LFMI

LFMI has analysed the Lisbon strategy and developed a comprehensive study on its impact on Lithuania

January 29, 2004, VILNIUS (Lithuania) – The core goals and objectives of the Lisbon strategy are not entirely coherent and can hardly be compatible, reported the Lithuanian Free Market Institute (LFMI), a private think-tank in Lithuania, after it has evaluated the Lisbon strategy and made an in-depth study on its impact on Lithuania and identified priorities for the country.

LFMI concluded that attempts are made to combine two different goals in the Lisbon agenda - to create conditions for economic growth and increased competitiveness, and at the same time to promote social benefits and social cohesion. LFMI also pointed out that some policy measures, currently being undertaken in Lithuania with regard to the country's membership of the European Union, run counter to the recommendations set in the Lisbon agenda.

LFMI is the first and, so far, the only institution in Lithuania which has undertook a thorough analysis of the Lisbon strategy. The study presents not only the Lisbon strategy, but also a detailed evaluation of Lithuania's priorities in reaching its targets and policy recommendations for relevant state institutions in Lithuania. The study discusses more specifically the goals and priorities laid down in the Lisbon agenda in the areas of entrepreneurship, employment, macroeconomic policy, education, health care, social cohesion and sustainable development.

The importance of the Lisbon strategy on the EU agenda and its relevance to Lithuania encouraged LFMI to take up this initiative. LFMI highlights that discrepancies between policy measures taken in Lithuania and the Lisbon goals are the primary reasons why Lithuania should have clear and articulated priorities. This analysis may well be considered the first framing of Lithuania's priorities of social and economic policy in the EU, as well as the basis for representing Lithuania's economic interests.

The study will be widely disseminated among the decision makers and the society in Lithuania. It has been contracted by the European Committee under the Government of Lithuania and co-financed by the local pre-accession assistance program of Danish Ministry of Foreign Affairs. The English summary of the LFMI's study can be downloaded on LFMI's website at: http://www.freema.org/Projects/Lisbon.phtml.

LFMI has been analysing issues of Lithuania's integration into the EU since 1998. It has conducted a number of impact assessment projects on the impact of EU accession on the road haulage, sea cargo, the energy and chemical industries in Lithuania, and an analysis of an overall impact of the EU membership on Lithuania's economy. In co-operation with foreign partners, LFMI has staged several international conferences about the consequences of the EU membership on candidate countries' economies and has taken an active role in the debates on the EU referendum in Lithuania. LFMI has also conducted a study about the future of Europe presenting

Lithuania's point of view concerning the reform of the EU and its institutions.

About the Lisbon strategy

The Lisbon strategy was adopted in 2000 at the summit of the European Union in Lisbon. Its ultimate goal is to attain that within a decade the European Union becomes "the most competitive and dynamic knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion." The basic motive to adopt this strategy was the EU's ambition to give fresh impetus to its lagging economy and to catch up with the US economy. Equally important was the EU's effort to bring together the EU member states for a new project by setting concrete guidelines and targets to be reached by co-ordinating economic policies of individual countries.

The implementation of the Lisbon strategy is currently among the main issues on the EU's economic policy agenda. Lithuania and other accessing countries joined the implementation process of the Lisbon strategy in 2003 and will meet with the EU member states to discuss the achieved progress in March this year.

About LFMI

The Lithuanian Free Market Institute (LFMI) is a private, non-profit and non-political organisation established in 1990 to advance the ideas of individual freedom and responsibility, free market and limited government. The Institute's team pursues its mission by conducting research on key issues of public policy, developing conceptual reform packages, drafting and evaluating legislative proposals, submitting policy recommendations at the legislative and executive levels, and conducting educational work in Lithuania. LFMI's activities also include sociological surveys, publications, conferences, workshops, and lectures.

Since its inception, LFMI has addressed a variety of core issues confronting the reform process. Not only has LFMI helped set the terms of debates but has also played a key role in helping to craft and refine legislative proposals. LFMI led the creation of the legal and institutional foundation for the capital market, a currency board system enshrined in the Law on Litas Credibility and sound operational principles and financial disclosure of commercial banks. LFMI formulated a proposal for tax and budget reform that improved the official policy as well as prepared the foundations for private pension insurance and the Law on Pension Funds. A profound impact was exerted on company, bankruptcy and competition law. LFMI has also initiated and provided a decisive input to national Sunset and Sunrise programmes aimed at sizing down bureaucracy and reducing business regulation. One of the basic priority areas of LFMI's research has been the European Union's impact on the economy and the life of people in Lithuania.

LFMI receives financial support from individuals, corporations and foundations. LFMI receives financial support from individuals, corporations and foundations. Devoted to the principles of private ownership, LFMI accepts no funds from the Lithuanian government.

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The Free Market is published by the Lithuanian Free Market Institute – an independent non-profit organisation established in 1990 to advance the ideas of individual freedom and responsibility, free market and limited government. Our motto is

If you don't create a free market, a black market will emerge

The founders of LFMI are – Prof. Kęstutis Glaveckas, Nijolė Žambaitė, Dainius Pupkevičius, Petras Auštrevičius, Elena Leontjeva and Darius Mockus.

LFMI pursues its mission by conducting research on key economic policy issues, developing conceptual reform packages, submitting policy recommendations at the legislative and executive levels, drafting and evaluating legislation, and launching public campaigns. LFMI's activities also include sociological surveys, publications, conferences, workshops, and lectures.

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